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IN THE

Supreme Court of the United States

OCTOBER TERM, 1951.

No. 613.

JEAN G. L. CASSEL VAN DOORN and
MARIJ V. CASSEL VAN DOORN,
Petitioners,

v.

WILLIAM HENIG, Trustee in Bankruptcy of
Regency, Inc., Bankrupt,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT.

BRIEF OF RESPONDENT IN OPPOSITION.

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Opinions Below.

The opinion of the Referee in Bankruptcy (R. 99a) is unreported. The opinion of the District Court (R. 110a) is reported in 96 F. Supp. 535. The opinion of the Circuit Court of Appeals (R. 175a) is reported in 192 F. 2d 574.

Jurisdiction.

The judgment of the Circuit Court of Appeals was entered on December 5, 1951 (R. 176). The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254 (1).

Questions Presented.

1. Are the decisions of the Referee, the District Court and the Court of Appeals subordinating the claims of the only two officers, directors and stockholders to the claims of all other creditors such a misapplication of the principles of equity as to require that they be reversed by this Court?

2. Does a decision of a State Court in a case in which the claims of the only two stockholders, officers and directors of a corporation were not and could not have been litigated preclude a Bankruptcy Court from subordinating those claims to the payment in full of all other claims?

3. Does Section 57(g) of the Bankruptcy Act make it mandatory that after restoration of wrongfully transferred property the claims of the wrongful transferees must be allowed on a parity with other claims?

Summary of Argument.

Petitioners have failed to show any special or important reason for review by this Court.

1. The equitable considerations involved in subordinating claims of fiduciaries, especially corporate directors, have been clearly set forth by this Court in *Pepper* v. *Litton*, 308 U. S. 295 (1939) and need no further exposition.

2. Inasmuch as the claims of the petitioners were not in any way litigated in the State Court, and, indeed, could not have been subordinated by the State Court, there is no question involving *res judicata* which would warrant review by this Court.

3. It does not follow that because Section 57g of the Bankruptcy Act provides that the claims of holders of voidable transfers shall not be allowed unless such creditors surrender such transferred property, and Section 57n of that Act gives such wrongful transferees 30 days in which to file claims arising in their favor by virtue of the recovery of such property by the Trustee, that after such restoration the Bankruptcy Court is precluded from subordinating on equitable grounds the claims of such wrongful transferees. It is obvious that such a construction, urged by petitioners, would enable the wrongful transferee, after restoration, to enjoy an invulnerability which other creditors would not enjoy. The contention of the petitioners is too obviously in error to require that it be settled by this Court. No decision in favor of the urged construction has been pointed out by petitioners.

The evidence amply supports the order of subordination, and no questionable precedents have been created by the opinions in this case.

Statement.

(Note: All exhibits referred to herein were offered at page 15a of the record.)

This is a petition for certiorari by the only two stockholders of the bankrupt corporation, to review a judgment of the United States Court of Appeals for the Third Circuit, which affirmed an order of the United States District Court for the District of New Jersey affirming on Petition for Review the order of the Referee subordinating their claims to the payment in full of all other creditors.

Regency, Inc., the bankrupt, was incorporated in 1941 (R. 142a). It sold all its capital stock to the claimant, *Baroness Marij V. Cassel van Doorn,* wife of the claimant,

Baron Jean G. L. Cassel van Doorn, for $50,000 (R. 146a). All shares were issued to the Baroness except 1 share issued to the Baron and 1 share issued to Abraham H. Sles, their attorney (R. 162a).

These three stockholders were elected directors in 1941, and, except for Mr. Sles, remained so until the petition in bankruptcy was filed (R. 134a). Mr. Sles ceased to be an officer, director and stockholder after December 5, 1944 (R. 82a, 136a). After 1941 no elections of any kind were held, no stockholders' meetings were held and only two other directors' meetings were held (R. 136a). No one was elected to succeed Mr. Sles as director and secretary after his resignation in 1944 (R. 134a).

The only enterprise in which Regency ever actually engaged was the purchase of four contiguous parcels in Englewood, New Jersey, and the making of alterations and additions thereto (R. 163a). It never owned nor dealt in personal property (R. 133a). The only use to which the real estate was put was as a residence for these two claimants (R. 135a, 163a).

The purchase of the first two parcels for $50,000 exhausted the initial capital (R. 146a).

Thereafter, without corporate authorization, the Baron and Baroness incurred obligations, allegedly on behalf of the bankrupt, amounting to $320,346.14, i.e. the Baron's claim of $290,675.79, the Baroness' claim of $8,796.35, John S. Westervelt's Sons, Inc.'s claim of $18,908.37 (without interest to the date of its judgment), Frank Ackerman's claim of $1,460.63 (disputed) and the claim of William J. Beyenberg, Jr. of $505.00 (R. 141a, 150a, 151a).

No corporate books of account were kept except two sets of bank check stubs covering 9 months from December, 1941 to September, 1942 (R. 135a) and a petty cash account which accounted for $47,689.97 (R. 23a to 25a).

The records show that the following items personal to claimants are included in the claims of the van Doorns:

> Photostats of the Baron's lease at Engle Street, Tenafly (R. 25a, 26a);
>
> Travelling expenses in connection with delivering a refrigerator to the Baroness (R. 27a);
>
> Repairs to radio and flat iron for Miss Pick, secretary to the Baron (R. 28a);
>
> Two refrigerators costing $782.53 (R. 43a, 74a, 75a);
>
> Frigidaire costing $258.50 (R. 44a);
>
> Custom built range costing $482.00 (R. 44a, 73a) and
>
> Kitchen cabinets in the sum of $1,315.00 (R. 44a, 73a).

These two claimants and their family and household moved into the premises early in February, 1944 (R. 19a) and have lived there ever since. Title was then in Regency, Inc., and remained so until January 29, 1945 (R. 114a-116a). No rent was paid to Regency for their occupancy (R. 133a, 163a). During that period telephone bills and real estate taxes were paid and included in petitioners' claims (R. 45a).

On January 29, 1945, the second of the three directors' meetings took place. The Baron and Baroness were then the only directors. A resolution was then adopted ratifying the Baron's expenditures in the sum of $290,675.79 as "necessary, desirable and advantageous to this company" and authorizing the conveyance of all of the real estate (which were the entire assets of the company) to the Baron at a valuation of $129,233, that "being the true and actual value of said properties." The corporation reduced its indebtedness to the Baron by the $129,233, transferred all its property to him and gave him its demand note, without interest, for the balance of $161,442.79 (R. 136a-141a). The

admitted purpose of this transfer was to enable the Baron "to deduct annually all real estate taxes assessed against said properties and thereby effect a substantial saving in his annual Federal income tax liability" (R. 157a, 151a).

After this meeting and transfer, Regency engaged in no further activities except to defend litigation and go into bankruptcy.

The transfer was subsequently declared to be in violation of Revised Statutes of New Jersey 14:14-2, N. J. S. A. 14:14-2 and void (R. 162a-167a).

John S. Westervelt's Sons, a creditor, was contractor for part of the alterations and additions to the Regency property. It instituted suit in the Bergen County Circuit Court on November 10, 1943, for the unpaid balance due for materials and labor, and recovered a judgment on February 16, 1948. This judgment being uncollectible, Westervelt's commenced an action in the Court of Chancery of New Jersey on March 25, 1948, for the purpose of having the transfer of the property set aside and also sought to have its judgment made a personal liability of the Baron and Baroness (R. 162a-164a).

One month thereafter, on April 23rd, 1948, Regency held its third and last directors' meeting, authorizing the filing of the petition in bankruptcy, and the petition was filed on that day (R. 136a, 164a).

Westervelt's obtained an order from the Referee in Bankruptcy dated July 14, 1948, permitting it to name the Trustee in Bankruptcy a party defendant in the Chancery suit and to continue to prosecute the action (R. 2a, 3a).

Thereafter, the State Court entered judgment, setting aside the transfer and directing a conveyance to the Trustee. It denied the application for a personal judgment against the van Doorns (R. 165a-167a). In its opinion the State Court said "All the plaintiff can ask is that the assets

of Regency, Inc., shall be made available for the payment of its claim'' (R. 162a-165a). This judgment was affirmed on appeal by the Appellate Division of the Superior Court of New Jersey. 3 N. J. Super. 173, 65 A. 2d 776 (1949).

After the entry of a supplemental judgment pursuant to the mandate, the van Doorns conveyed the property to the Trustee and paid him $25,000 representing the proceeds from the sale of part of the premises in 1946, and the Baron amended his claim to include the $129,233 for which he had allowed credit at the time of the voided conveyance. He refused to deliver possession to the Trustee and appealed to the Appellate Division of the Superior Court of New Jersey from that part of the supplemental judgment ordering him to do so. This appeal resulted in a judgment of affirmance. 5 N. J. Super. 231, 68 A. 2d 755 (1949).

Thereafter, the real estate was sold by the Trustee to the claimant, Marij V. Cassel van Doorn for $90,000 (R. 77a).

The Trustee filed objections to the van Doorn claims and on October 24th, 1949 amended objections to these claims were filed (R. 4a, 9a to 13a).

The Referee allowed the van Doorn claim but subordinated them to the payment in full of all claims of other general creditors (R. 99a to 103a). This was affirmed on review by the District Court (R. 110a, 111a) and again by the Court of Appeals (R. 175a, 176a). It is to review this action that the writ of certiorari is presently sought.

ARGUMENT.

Petitioners have failed to show any cogent reason for review by this Court. It has not been shown that there is any conflict between circuits on any question herein presented. Nor has it been demonstrated that this Court has not decided any important question raised in this case.

At most it is suggested that certain principles involved are not too clearly established and that a further review of them "may be advisable" (Petition, p. 8).

An examination of the principles involved here will show that such is not the case.

POINT I.

The equitable principles involved have been clearly enunciated by this Court.

It is first urged by petitioners that the principles giving rise to subordination of claims are not "too clearly defined" (Petition, p. 7).

The equitable principles which would warrant the disallowance or subordination of the claims of corporate stockholders, officers and directors are set forth clearly by this Court in the case of *Pepper* v. *Litton* (1939), 308 U. S. 295; 84 L. Ed. 281; 60 S. Ct. 238; 41 A. B. R. (N. S.) 279. They are as follows:

A. "A director is a fiduciary . . . so is a dominant or controlling stockholder or group of stockholders. . . . Their dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with the corporation is challenged, the burden is on the stockholder as director, not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein. The essence of the test is whether or not under all the circumstances, the transaction carries the earmarks of an arms length bargain. If it does not, equity will set it aside. . . . For that standard of fiduciary obligation is designed for the protection of the entire community of

interests in the corporation—creditors as well as stockholders" (308 U. S. at p. 306).

This Court cited on this point *Geddes* v. ***Anaconda Copper Min. Co.*** (1921), 254 U. S. 590; 65 L. Ed. 425; 41 S. Ct. 209.

B. The result, i.e. of disallowing or subordinating a claim "is reached where the claim asserted is void or voidable because the vote of the interested director or stockholder helped bring it into being . . ." (at p. 309).

C. The result of disallowing or subordinating a claim is also reached "where the history of the corporation shows dominancy and exploitation on the part of the claimant" (at p. 309).

D. Disallowance or subordination "is also reached where on the facts the bankrupt has been used merely as a corporate pocket of the dominant stockholder, who, with disregard of the substance or form of corporate management, has treated its affairs as his own" (at p. 309).

E. So-called loans or advances by the dominant or controlling stockholder will be subordinated to claims of other creditors and thus treated in effect as capital contributions by the stockholder not only in the foregoing types of situation (i.e. as set forth in paragraphs B, C, and D above) but also where the paid-in capital is purely nominal, the capital necessary for the scope and magnitude of the operations of the company being furnished by the stockholder as a loan" (at pp. 309-310).

F. At page 311 this Court pointed out that Litton had allowed his claim to remain dormant for years and used it only when financial difficulties arose and another creditor tried to collect a debt, and that Litton then used his claim

to impair the creditor's claim. Litton had meanwhile acquired most of the assets not for cash or other consideration of value to other creditors, but for bookkeeping entries. This Court then said:

"This alone would be a sufficient basis for the exercise by the District Court of its equitable powers in disallowing the Litton claim."

Summing these up, this Court stated:

> "Though disallowance of such claims will be ordered where they are fictitious or a sham, these cases do not turn on the existence or non-existence of the debt. Rather they involve simply the question of order of payment. At times equity has ordered disallowance or subordination by disregarding the corporate entity. That is to say, it has treated the debtor-corporation simply as a part of the stockholder's own enterprise, consistently with the course of conduct of the stockholder. But in that situation as well as in the others to which we have referred, *a sufficient consideration may be simply the violation of rules of fair play and good conscience by the claimant;* a breach of the fiduciary standards of conduct which he owes the corporation, its stockholders and creditors" (at p. 310. Emphasis supplied).

It is submitted that this Court has already clearly defined the principles involved in subordination of claims and therefore the first point urged by petitioners for a review (Petition pages 7 and 8) does not set forth a special and important reason therefor (Supreme Court Rule 38, par. 5).

POINT II.

There is no question of *res judicata* which would warrant review by this Court.

The petition is based on an alleged misapplication by the courts below of the decision of this court in *Heiser* v. *Woodruff*, 327 U. S. 726, 66 Sup. Ct. 271, 90 L. Ed. 970 (1945) and upon the assumption that in that case this Court overruled its earlier decision in *Pepper* v. *Litton*, 308 U. S. 295, 60 Sup. Ct. 238, 84 L. Ed. 281, 41 A. B. R. (N. S.) 279 (1939).

The suit in the Superior Court of New Jersey, which is claimed to be a bar to the order of subordination in the Bankruptcy Court, was commenced prior to the adjudication in bankruptcy. It was instituted by a judgment creditor of Regency, Inc. for the primary purpose of having the conveyance by that corporation of all its assets to Baron van Doorn, one of the petitioners, set aside.

As a further relief, and in order to end the litigation started over four years earlier, the creditor prayed that the Baron and Baroness van Doorn, sole stockholders, directors and officers, be decreed to pay the creditor's judgment personally.

That action resulted in a decision setting aside the conveyance but denying the prayer for a money judgment against the van Doorns in favor of that creditor (R., 162a; 1 N. J. Super. 466, 63 A. (2d) 818).

An analysis of the pertinent part of the state court action shows that the issue there presented was:

Have these two people, or either of them, so handled the affairs of their wholly owned corporation that under the applicable principles of *New Jersey law* they should be made to pay from their personal funds the judgment of John S. Westervelt's Sons against their corporation?

If the state court had granted the relief sought, the petitioners would have had to pay additional money from their personal funds, if they were able to.

But the state court did not squarely answer the above question. Instead, it held that because the judgment creditor had contracted with Regency and not with the van Doorns it was barred from looking to the personal assets of the van Doorns and all it could ask "is that the assets of Regency, Inc., shall be made available for the payment of its claim" (R. 165a). It expressly ruled that the cases involving piercing the corporate veil were not in point.

It will be noted that the decision of the Bankruptcy Court is not inconsistent with the decision of the state courts, because it did in fact make the assets of *Regency* available to the creditors for the payment of their claims.

The claims of the petitioners were not involved in the action in the state court. It was not within the scope of the issues in that action to determine whether these claims were valid obligations of the bankrupt, or, if valid, in what amounts.

Furthermore, the allowance or disallowance of these claims in bankruptcy not only was not within the issues of that action but also was not within the jurisdiction of that court.

In *Pepper* v. *Litton* (above) this Court held that in that respect the jurisdiction of the bankruptcy courts is exclusive of all other courts.

Therefore, since the order of subordination was not only *not* litigated but also could not have been litigated in the state court, the doctrine of *res judicata* does not apply.

A reading of the decisions of this Court in *Heiser* v. *Woodruff* (above) and *Pepper* v. *Litton* (above) makes it

clear that the former does not overrule the latter, with reference to the effect of *res judicata.*

In any event, the present case is clearly distinguishable from the *Heiser* case. In the *Heiser* case the claimant was not a fiduciary, and his claim itself had twice previously been litigated. Here the claimants are both fiduciaries and their claims have not been previously litigated.

The courts below have correctly interpreted the applicable decisions of this Court with reference to the inapplicability of *res judicata* here, and therefore this ground does not warrant a review by this Court.

POINT III.

Restoration of preference does not preclude subordination.

The third ground petitioners urge for granting the writ does not warrant extended discussion. It is, in effect, that, since they complied with the judgment of the state court and restored the wrongfully transferred property, the bankruptcy court is required by Sections 57g and 57n of the Bankruptcy Act (set forth in appendix) to allow their claims on a parity with other creditors of the same class.

A reading of the sections shows that the Act provides that without restoration the claims *cannot* be allowed, but it does not provide that with restoration the claims *must* be allowed.

It cannot logically be argued that these sections bar any consideration of subordination or disallowance of any claim by a claimant who had enjoyed a preference once the property has been restored. Such a conclusion would give a fraudulent transferee, after restoration, an invulnerability not enjoyed by other creditors, who are innocent of any preferential transfers.

The trustee did not base his objections on the ground of this transfer alone (R. 9a-13a) but merely asserted it as one of several considerations to be weighed in determining whether the petitioners should have their claims allowed on a parity with claims of other creditors.

Such a transfer was considered as a factor in *Pepper* v. *Litton* (above) and in *Goldie* v. *Cox* (C. C. A. 8th, 1942), 130 F. (2d) 695.

It is submitted that the construction of the above sections of the Bankruptcy Act urged by petitioners is too clearly erroneous to require review by this Court.

Conclusion.

The question of subordination of claims on equitable principles generally turn on the facts of each case.

An examination of the facts in the Statement, ante, will show that there is ample evidence to support the order involved in this case.

No questionable precedent is created by any of the opinions filed in this case, and the unusual situation of dominant stockholders, as directors, causing the corporation to strip itself of its entire assets and saddle itself with a hopeless debt of $161,442.79 in the same resolution (R. 136a to 141a) for the sole avowed purpose of enabling the holder of one share of stock to deduct real property taxes on his personal income tax return (R. 151a, 157a) would undoubtedly distinguish this case from future cases.

No cogent legal reason having been advanced for a review by this Court, and the conclusions drawn being amply supported by the evidence, it is respectfully submitted that the petition for certiorari should be denied.

PAUL T. HUCKIN,
Attorney for WILLIAM HENIG, Trustee in Bankruptcy for Regency, Inc., Bankrupt Respondent.

Appendix.

Section 57 (g) Bankruptcy Act, U. S. C. A. Title 11, Sec. 93g, provides:

> "(g). The claims of creditors who have received or acquired preferences, liens, conveyances, transfers, assignments or encumbrances, void or voidable under this title, shall not be allowed unless such creditors shall surrender such preferences, liens, conveyances, transfers, assignments or encumbrances."

Sub-section (n.) of the same section U. S. C. A. Title 11, Sec. 93 (n) provides in part:

> "(n.) . . . And provided further, that a claim arising in favor of a person by reason of the recovery by the trustee from such person of money or property, or the avoidance by the trustee of a lien held by such person, may be filed within thirty days from the date of such recovery or avoidance, but if the recovery is by way of a proceeding in which a final judgment has been entered against such person, the claim shall not be allowed if the money is not paid or the property is not delivered to the trustee within thirty days from the date of the rendering of such final judgment, or within such further time as the court may allow . . ."